

Competing in the New Retirement Plan Market: Tips for Leveraging Regulatory Challenges Through Non-Fiduciary Value-Added Services

By Jason C. Roberts, Esq.

I. Introduction

Sweeping reforms to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) are scheduled to become effective in 2012, and a number of the new requirements will present particularly significant and unique challenges to financial service providers. These difficulties are compounded by the fact that most small and mid-sized firms typically do not employ in-house ERISA expertise. Even many of the larger firms, which may have adequate resources, traditionally have not viewed retirement plan services as a major profit center. Unfortunately, ERISA does not distinguish between large and small service providers. The rules apply equally, and the prohibitions (and exemptions) depend upon nature and scope of the services actually rendered, regardless of the labels a firm may place upon its representatives or any attempts to limit liability through contract.

While the penalties for violations of ERISA are substantial (particularly for those considered to be providing fiduciary services), so, too is the revenue generated from the sale and servicing of retirement plans. Not only do firms benefit directly by way of 12b-1 and/or asset-based fees, most realize significant “ancillary” profits from cross-selling and IRA rollovers, for example. Because the new regulations present different but often equal challenges to plan sponsors, significant opportunities exist for firms that provide services that align with the needs of their clients. In order to capitalize successfully on the changes to come, these firms will need to do two things: (i) evaluate their current and desired services against the backdrop of heightened scrutiny and full fee disclosure; and (ii) prepare their retirement plan advisers to compete with those offering more holistic support to sponsors and participants and educate home office personnel accordingly. This article provides a strategy for firms to consider when developing and deploying competitive and compliant approaches for servicing ERISA-covered retirement plans.



Jason C. Roberts is the Founder and CEO of the Pension Resource Institute (PRI) providing strategic consulting and training to retirement plan service providers (broker-dealers, RIAs, investment managers, recordkeepers, TPAs, etc.) and fiduciary education to plan sponsors. Prior to founding PRI, Jason was a partner and co-chair of the Financial Services Group at Reish & Reicher – a leading ERISA law firm – where his practice focused on employee benefits and securities regulation.

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II. Assess Risks and Determine the Services to Be Provided

Fiduciary status under ERISA carries with it the highest duty of loyalty and prudence. Also, ERISA fiduciaries are subject to strict rules concerning prohibited transactions. In some instances, these rules extend to participant-level services, including cross-selling and IRA rollovers.¹ As such, the evaluation process should begin with a risk assessment and an alignment of goals to current resources. Many firms may find that they do not have the requisite expertise to adequately supervise ERISA fiduciary services and will need to limit the activities of their advisers in this regard. A thorough understanding of how the pending requirements and proposed changes affect fiduciary status is, therefore, crucial to analyzing risks.

The most important regulations on financial service providers are plan-level fee disclosure under ERISA 408(b)(2) and participant-level disclosures under 404(a)(5) both of which are final and scheduled to become effective January 2012.² The DOL also recently issued a proposed rule that seeks to redefine the scope of activities giving rise to fiduciary status under ERISA. While the rule has not been finalized, firms should consider the effect of the proposed rule on its desired strategy in order to ensure that the proffered services are viable under the expanded definition of fiduciary.

a. Definition of Fiduciary – Current Rule

Under the current law, there are three ways in which one can become a fiduciary: (i) exercising discretion over the management or administration of the plan; (ii) exercising discretion over the management or disposition of plan assets; or (iii) providing investment advice for compensation (directly or indirectly). The test is functional, which means that it doesn't matter whether one disclaims fiduciary status. Financial advisers and their firms typically become fiduciaries under the third scenario.

ERISA requires plan sponsors to manage the plan's investments prudently; if they do not possess the requisite expertise, they are required to hire someone who does. In participant-directed plans, there are often hundreds or even thousands of investments available on the custodial/recordkeeping platform. Because plan sponsors are also required to furnish specific information on plan investments, they generally will seek to narrow them to 10 – 20 options (a.k.a. designated investment alternatives or "DIAs") to allow partici-

pants to allocate among them to create well diversified portfolios. Plan sponsors, consequently, rely on their financial advisers (typically the person who sold them the plan or has taken over as the broker of record) for advice with respect to the initial selection, ongoing monitoring and replacement of the plan's DIAs.

Under the current rule, in order to be considered *fiduciary* "investment advice," the adviser's recommendations must: (i) relate to the value or advisability of investing in securities or other property; (ii) be rendered on a regular basis; (iii) pursuant to an understanding that; (iv) such advice will serve as the primary basis for investment decisions; and (v) is individualized based upon the needs of the plan and/or its participants. Nevertheless, courts have increasingly found that even registered representatives or insurance agents, whose supervising firms typically prohibit the rendering of fiduciary services to ERISA-covered clients (and in some cases disclaim such status in writing), were nonetheless acting as fiduciaries in assisting plan sponsors and/or participants in selecting among available investments.³

This result is problematic in a number of respects. To begin, ERISA requires that those who make investment decisions engage in a prudent process. Most advisers that do not specialize in providing fiduciary services do not follow a formal documented process when selecting or removing investments. More importantly, however, ERISA's prohibited transaction rules prohibit fiduciaries from rendering investment advice that can affect their compensation or that of an affiliate. If the adviser is compensated from commissions or 12b-1 fees that vary from fund-to-fund or if the adviser is affiliated with an investment manager or broker-dealer that receives additional compensation (i.e., management fees, revenue sharing, markups, etc.), the rendering of investment advice would be a prohibited transaction and could subject the adviser to personal liability and his firm to significant penalties (e.g., disgorgement, excise taxes, etc.).

The majority of errors and omissions insurance policies do not cover fiduciary services rendered by broker-dealers or insurance agents for these reasons. Even if coverage is available, services outside of the firm's policies and procedures are typically excluded, and most broker-dealers and insurance companies prohibit advisers and agents from acting as a fiduciary in this capacity; the firms that permit such services typically require advisers to provide them through an RIA, and many require advisers to qualify into those programs.

b. Definition of Fiduciary – Proposed Rule

In October 2010, the DOL issued a proposal to redefine the term “investment advice” by eliminating some of the requirements of the aforementioned five-part test and including additional activities such as advice or recommendations relating to the selection of investment managers.⁴ For example, under the proposed regulation, there is no requirement that the advice or recommendations be rendered on a regular basis or that there be an understanding that it will be the “primary basis” for investment decisions; if there is an understanding or agreement that the advice “may be considered” in connection with a plan investment decision, such advice would give rise to fiduciary status under ERISA.⁵ In addition to the lower threshold, RIAs are singled out and presumed to be providing investment-related services as an ERISA fiduciary, and if the advice is customized to the investment profile of the client, broker-dealers and insurance companies will likely be considered ERISA fiduciaries. As such, it is important to anticipate and evaluate the effect of the proposed expansion of fiduciary status when developing and/or redefining the firm’s services to be provided to ERISA-covered clients.

III. Plan-Level Fee Disclosure Under ERISA 408(B)(2)

Although the expanded definition of fiduciary investment advice under ERISA is only a proposal at the time of this writing, the plan-level fee disclosure regulation has been finalized and will become effective January 1, 2012.⁶ The “interim-final” regulation was published on July 16, 2010 requiring service providers to employer-sponsored retirement plans to disclose information to assist plan fiduciaries in understanding the reasonableness of the fees being charged for plan services and assess potential conflicts of interest that might affect the quality of those services.⁷ Specifically, the regulation requires all “covered” service providers to deliver written disclosures setting forth: (i) all services to be provided to the plan and/or its participants; (ii) any and all direct and/or indirect compensation received by the service provider (and affiliates); and (iii) a statement acknowledging any of the services that are reasonably expected to give rise to fiduciary status under ERISA or the Advisers Act.

The required disclosures pose a number of challenges to financial service providers. For example, the majority of broker-dealers have never articulated

the services their advisers provide to ERISA-covered plans because they are compensated from commissions and 12b-1 fees paid by the plan’s investments. Plan sponsors, for the most part, did not question the services that were viewed as “free.” This lack of clarity has left many plan sponsors with the impression that the adviser and firm are co-fiduciaries to their plans, and conflicts of interest have been difficult to

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ascertain. Plan sponsors are expected to re-negotiate compensation arrangements with their adviser in light of any perceived or actual reduction in services (e.g., investment advice is not a disclosed service). Firms that are not prepared to realign their value propositions may lose the business to first movers that disclose more holistic services for the same compensation.

IV. Participant-Level Fee Disclosure Under ERISA 404(A)(5)

The DOL issued its above-referenced plan-level fee disclosure regulation as part of a three-part initiative aimed at facilitating the exchange of information among service providers and plan sponsors, plan sponsors and the DOL (via Schedule C of Form 5500), and plan participants. In October 2010, it published its final participant-level disclosure regulation under ERISA 404(a)(5) requiring plan sponsors to provide each participant, or beneficiary, with two categories of information: (i) plan-related information, including general plan information, administrative expense information and individual expense information; and (ii) investment-related information, including performance data, benchmarking information, fee and expense information, internet web access to investment-related information, and a glossary to assist participants with investment-related terminology. Both categories of disclosures must be presented to the

plan participant prior to the participant's first direction of investments and annually thereafter. Further, the new rule requires that this information be provided in a comparative format such as a chart or similar format, and the information must be provided in plain language the average participant can understand.⁸

In addition to the plan-related information that must be furnished up front and annually, participants must receive statements, at least quarterly, showing

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the dollar amount of the plan-related fees and expenses (whether "administrative" or "individual") actually charged to or deducted from their individual accounts, along with a description of the services for which the charge or deduction was made.

While nothing affirmative is required on the part of plan service providers under this regulation (service providers are required to disclose sufficient information under 408(b)(2) to allow plan sponsors to meet their requirements under 404(a)(5)), recent surveys indicate that the majority of plan participants currently believe that their plans are "free" or that the plan sponsor is paying most or all of the plan expenses. Consequently, advisers should be prepared to defend their value to participants who will now see the fees paid from their investments to the broker-dealer, adviser or both. Participants who are not satisfied with the explanation of services relating to fees deducted from their accounts are likely to look to the DOL for substantiation.

V. Assessing Value and Defining Services

The combined effects of the plan- and participant-level disclosures will serve as a guide not only for plan sponsors and participants but also for regulators and potential plaintiffs. It is, therefore, imperative that firms begin to assess the compensation

they receive in light of the value of their services. A supervising firm's ability to support ERISA-covered services typically depends upon two factors: (i) the sophistication of its retirement plan advisers; and (ii) its back office strength. As a result of the foregoing, many firms have simply elected to pull back on approved services offered to ERISA-covered plans and plan participants leaving their advisers to ask – "what is left for me to do?" – and advisers who specialize in servicing retirement plans are beginning to search out firms that will allow them to continue to provide more robust services to ERISA clients. While it may be prudent for some firms to rein in services that may give rise to fiduciary status (e.g., due to lack of supervisory resources, less experienced advisers, product conflict, etc.), there are a number of valuable, non-investment related services that can allow advisers to remain relevant and competitive in the retirement plan marketplace.

a. Filling the Advice "Gap"

As discussed above, sponsors have traditionally looked to their adviser for guidance on managing the plan's investment options. If firms elect to prohibit investment-related services due to the above-referenced challenges, they need to determine how this void will be filled such that the sponsor doesn't seek to replace the adviser with one that can provide such support. Fortunately, many plan providers (i.e., custodians, recordkeepers, third-party administrators, etc.) are now making investment advice or management services available through third-parties that provide services remotely. These "outsourced" solutions can remove the temptation for plan advisers to render fiduciary investment advice at the plan and/or participant level, and non-fiduciary advisers can continue to sell additional products to and capture IRA rollovers from plan participants without running afoul of ERISA's prohibited transaction rules.

Filling the advice gap, however, is only part of the equation. Advisers must be able to justify their fees by providing value added services. With the right training and tools, proactive firms can offer a robust menu of non-fiduciary services that align with the needs of sponsors and participants – provided they do so in a carefully constructed and monitored model. The remainder of this article outlines how firms can develop and deploy successful non-fiduciary programs for their retirement plan clients.

b. Adviser Training and Plan Sponsor Education

As discussed above, the new regulations will present a number of challenges to plan sponsors. For example, most small and mid-sized sponsors often lack the time or the inclination to stay abreast of their requirements. Sponsor education, therefore, can be a sought-after service and may serve as a valuable retention strategy for advisers. Firms that equip their advisers with the necessary training and tools to support sponsors in staying current and/or managing the disclosure and reporting process, for example, will differentiate themselves from those less experienced in this regard. There are a number of consulting firms that specialize in providing this type of ERISA- or retirement plan-specific training to advisers and home office personnel.

Effective education can also be a determining factor in preventing DOL examinations and/or litigation resulting from participant inquiries and/or formal complaints. As mentioned above, participants will soon be provided with information about the fees deducted from their accounts, and most will be surprised to learn that the plan and the services provided to the plan and its participants are not free. Firms that arm their advisers with sufficient information to demonstrate the value of their services, the reasonableness of their fees and the customary nature of the same will benefit from not only more holistic and competitive services but also from the mitigation of risks associated with regulatory action and/or litigation. Moreover, properly trained advisers can assist sponsors with evaluating the services and defending the fees charged by the plan's other service providers (i.e., recordkeepers, investment managers, TPAs, etc.) further adding to the adviser's value proposition and limiting risk to the sponsor (and indirectly to the adviser and his/her firm).

Education should provide the adviser with the tools to help plan sponsors prepare for the changes to come. For example, there is a number of ways that advisers can assist sponsors with evaluating plan- and participant-level disclosures. While perhaps prohibited from rendering "investment advice," advisers will often be the most knowledgeable person to assist the sponsor in locating and examining investment-related information (e.g., fees, share classes, potential conflicts of interest, etc.). By proactively bringing this expertise to the

attention of the fiduciaries (through the creation of checklists, monitoring procedures, etc.) advisers can help to ensure that they are ahead of the curve and part of the solution – leading to enhanced retention and prospecting.⁹

Experienced advisers will often recommend procedures to the sponsor to help them effectively administer the plan and help with implementing those procedures. For example, it will be necessary for sponsors to track and manage participant inquiries and/or complaints. Simple procedures that provide for escalation of inquiries and complaints to the appropriate individual(s) can be quite useful, as the primary source for DOL audits is an un-responded to participant complaint. While the adviser can serve as the first line of defense, the issue may need to be referred up.

Properly trained advisers can also introduce effective procedures to form and maintain plan committees. Indeed, smaller plans with fewer resources benefit by a more streamlined approach to decision-making and documentation, as procedures are more likely to be followed when each committee person has a single focus and clearly understands the consequences of failing to act prudently in carrying out their fiduciary duties. Advisers that can offer support in this regard will further differentiate their services from the competition.

Lastly, advisers who understand the limits imposed under ERISA can provide investment-related information to participants without crossing the line into fiduciary investment advice. DOL Interpretative Bulletin 96-1 outlines the nature and scope of materials that are considered non-fiduciary investment education. Many firms and their advisers are surprised at the latitude afforded to them under 96-1.¹⁰ For example, the adviser can introduce interactive risk tolerance questionnaires and show the effect of investing in asset allocation models for hypothetical investors with a given risk tolerance and investment time horizon. Effective participant education can provide yet another way for advisers to demonstrate value and differentiate themselves.

VI. Developing and Testing Procedures

Once the proffered services are identified, they should be tested by examining the flow of required documents and information between (i) the firm

and the plan and (ii) the adviser and the firm, developing ERISA-specific policies and procedures, and conducting appropriate due diligence on the tools required to support each offering. Waiting until the services have been confirmed saves considerable time in the development of procedures because the procedures need to be specific to the agreed-upon services. To the extent programs offered by third parties are to be introduced as part of the services, the firm should incorporate into the procedures any requirements, limitations or criteria for use or distribution of third-party materials by the adviser.

The firm should evaluate its current resources (i.e., operations, compliance, supervision, etc.) and identify any gaps in the infrastructure specific to the desired services. The procedures should be tested on a periodic basis – perhaps in tandem with routine annual due diligence reviews – to confirm that the process has been followed and either that no material changes have been made in process or personnel, or else to document those changes. Only after determining the resources, data, policies and procedures required to support each discrete offering can a supervising firm successfully implement a compliant and sustainable suite of ERISA-covered services.

VII. Developing Required Disclosures

Once the foregoing analysis is completed, new agreements and/or written disclosures should be developed to comply with the specific requirements of the 408(b)(2) regulation. The final regulation does not require written service agreements, so broker-dealers and insurance companies may

opt to provide the required information through disclosures alone.¹¹ That said, written agreements can be drafted to contain the disclosures and memorialize the services to be provided – and perhaps more importantly – to disclaim responsibility for services not provided. Having a written agreement also helps to ensure that disclosure has been made to the appropriate person (the responsible plan fiduciary), and it can be used to collect information about the plan that may help to monitor the services being provided.

VIII. Conclusion

Once the firm has completed the foregoing, it should seek to procure ongoing education to ensure compliance with new regulations and evolving DOL guidance. Again, strategies will vary from firm to firm. The above-referenced steps are meant to serve as a guide to consider when responding to the challenges presented by pending requirements. Some firms may have more or fewer issues to consider based upon their affiliates, internal resources, adviser demographics, etc. While the value proposition issue is more acute for broker-dealer and insurance companies, robust non-fiduciary services can help fee-based advisers and consultants differentiate themselves by offering more sophisticated, holistic support to their clients. As the new regulations begin to come to fruition over the next year, firms that can demonstrate proficiency with the resulting challenges will be well-positioned to retain their existing clients and advisers and to attract new business and recruit advisers that seek to grow their retirement plan business.

ENDNOTES

¹ See DOL Advisory Opinion 2005-23A discussing the limitations imposed upon ERISA fiduciaries relating to cross-selling to plan participants at <http://www.dol.gov/ebsa/regs/aos/ao2005-23a.html>.

² The 408(b)(2) rule was technically published as “Interim Final,” but the outstanding items are expected to relate solely to format and presentation of the disclosures; the disclosure requirements are not expected to change. In June 2011, the DOL published its notice to align the effective date of the 404(a)(5) regulation with 408(b)(2).

³ See e.g., *Ellis v. Rycenga Homes, Inc.* (April 2007) available at: http://mi.findacase.com/research/wfrmDocViewer.aspx/xq/fac.20070402_0000385.WMI.htm/qx

⁴ See proposed rule at <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24328>.

⁵ A safe harbor may be available if it can be “demonstrated” that the client knows or reasonably should know that: i) the advice or recommendations are being made by the adviser in its “capacity as a purchaser or seller” of securities or other property; and ii) the adviser is not undertaking to provide “impartial investment advice.” The proposal

further states that “investment advice” shall not include a platform provider’s marketing or making investment alternatives available to a plan (without regard to individual needs of a plan) or providing general financial information to assist a plan fiduciary’s selection and monitoring of such investment alternatives, so long as the platform provider discloses in writing that it is not providing impartial investment advice. At this time, however, the availability and scope of this relief is still somewhat unclear.

⁶ While the rule was previously scheduled to become effective in July 2011, the DOL extended

the date to January 1, 2012 "to ensure a careful review of all the valuable input [it] received on the interim final rule, including suggestions for a summary document to further assist plan fiduciaries in their review of furnished information. The DOL's June 2011 announcement to "align" the 404(a)(5) regulation with the effective date of 408(b)(2) noted that the DOL "recognizes that because a final rule is not yet in place, service providers may need additional time for compliance."

⁷ See interim-final rule at <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24028>.

⁸ See final rule and model comparative chart at <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24323>.

⁹ See e.g., supporting materials available at www.pension-resources.com/resources/adviserresource/series/disclosuremanagement.

¹⁰ See DOL Interpretative Bulletin 96-1 at http://www.dol.gov/ebsa/regs/fedreg/final/96_14093.pdf.

¹¹ In the case of fee-based advisory programs, written agreements and disclosures in the Form ADV Part II are required under the Investment Advisers Act of 1940. Given the complexity and the manner in which the ERISA disclosures must be made, RIAs should develop ERISA-specific investment advisory agreements and supplement the Schedule F to the Form ADV Part II to reflect the covered services.

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